

b. Costs

The Commission does not believe there would be any costs associated with altering the odd-lot and domestic arbitrage exceptions, eliminating the equalizing exception, creating new exceptions relating to locked or crossed markets and facilitating customer orders, and codifying existing VWAP exemptive relief. The Commission seeks comment, however, on whether any such costs exist, and if so, data to support such costs.

B. Proposed Rule 203: Locate and Delivery Requirements

1. Benefits

Proposed Rule 203 would enhance locate and delivery requirements for short sales in all equity securities. These changes are proposed in response to complaints from many issuers and investors concerning allegations of abusive "naked short selling." The Commission proposes to adopt safeguards to address the problems associated with large persistent failures-to-deliver. The Commission believes that this requirement would help curtail manipulative naked short selling.

The Commission believes that it would be beneficial to establish uniform procedures to be utilized by short sellers to locate securities for borrowing, which could help promote and enhance the national clearance and settlement system. The Commission is proposing to prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale rule is executed: (1) Borrowed the security, or entered into an arrangement for the borrowing of the security, or (2) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the delivery date it is due. This uniform rule would further the goals of regulatory simplification and avoidance of regulatory arbitrage. Please describe any additional benefits resulting from the proposed uniform locate requirements.

The Commission is also proposing additional delivery requirements targeted at securities where there is evidence of large settlement failures. The proposal would specify that a short sale in any security that meets the threshold, *i.e.*, any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more, and that is equal to one-half of one percent of the issue's total shares outstanding, must be delivered, or the broker-dealer would be

required to enter into a contract to borrow the security, or effect a buy in so that, in either event, the security would be delivered within two days after the settlement date. If the securities are not delivered within two days after the settlement date, for a period of ninety calendar days the broker or dealer shall not execute a short sale in such security for his own account or the account of the person for whose account the failure to deliver occurred unless the broker or dealer or the person for whose account the short sale is executed has borrowed the security, or entered into a bona fide arrangement to borrow the security, and will deliver the security on the date delivery is due. The proposed Rule would also require the rules of the registered clearing agency to include the following provisions: (A) A broker or dealer failing to deliver securities as specified in subparagraph (3) above shall be referred to the NASD and the Examining Authority (as defined in 15c3-1(c)(12)) for such broker or dealer for appropriate action; and (B) The registered clearing agency shall withhold a benefit equal to any mark to market amounts or payments that otherwise would be made to the participant failing to deliver, and assess appropriate charges.

The Commission believes that these additional delivery requirements would protect and enhance the operation, integrity, and stability of the markets. In particular, this requirement is targeted at securities with lower market capitalization that may be more susceptible to abuse. We also believe that clearly articulated rules restricting naked short selling would assist the Commission in its enforcement efforts.

The Commission believes that a large amount of fails at the clearing level may impose costs on the clearing agency. For example, certain issuers have taken steps to make themselves either "certificate only," which require physical certification of company ownership for all share transfers, or "custody only," which restricts ownership of their securities by depositories or financial intermediaries. The Commission believes these custody arrangements are highly costly to the clearing agencies, depositories and financial intermediaries. The Commission believes this proposed additional delivery requirement would provide a benefit because it would mitigate some of these costs. Please provide data supporting this, and any other, benefit that the proposal would provide in mitigating such costs, including benefits to clearing agencies, depositories and financial

intermediaries in implementing and complying with this proposal.

Proposed Rule 203 would also make two changes to existing long sale delivery rules. First, the rule would extend current delivery requirements for long sales of listed securities to all equity securities, including Nasdaq NMS, Nasdaq SmallCap, OTCBB, and Pink Sheet securities. The intended benefits of this change are uniformity across markets and a reduction in the number of fails to deliver on long sales. Moreover, the Commission believes that this modification would facilitate the process of clearance and settlement. The amended rule would also permit a broker-dealer effecting a long sale to fail to deliver, or to deliver borrowed securities, if prior to the sale, the seller told the broker-dealer he owned the security and would deliver it to the broker-dealer prior to settlement. This change is necessary to conform the proposed rule with proposed Rule 201(c), which would require an order to be marked long only if the seller informs his broker-dealer that he owns the security and the broker-dealer will have physical possession or control of the security prior to settlement. It is intended that this change would both reduce the number of over-the-counter fails, and facilitate the process of clearance and settlement. The Commission requests data to quantify the value of the benefits identified.

2. Costs

The Commission recognizes that the proposed locate and delivery requirement may increase costs for market participants who engage in short selling. However, we believe that these costs would be minimal, because the proposed rules largely incorporate existing SRO locate rules, such as NYSE Rule 440C.10 and NASD Rule 3370. The Commission is, however, proposing an exception from these requirements for short sales executed by specialists or market makers in connection with bona fide market making activities. In addition, any costs that may be initially incurred would be mitigated over time because the uniform rule should lead to regulatory simplification with regard to training and surveillance. Please describe any additional costs resulting from the proposed uniform borrow requirements to market participants already subject to locate requirements by SROs. The Commission requests data to quantify the costs identified.

This proposal would apply to all equity securities, including securities that have quotations published on the OTCBB and Pink Sheets. Issuers and investors have complained about